

ACCOUNTING AND REGULATION---ANNUAL STATEMENTS (111-1)

[Uniformity in insurance reporting allows comparisons among insurers and provides more useful and meaningful information.

Insurance accounting responsibilities have increased in recent years due to crossovers of property-casualty insurers into life insurance and life insurers into the property-casualty business, due to revisions to the Annual Statement, and due to the NAIC's formation of accounting-related committees.]

EO 1. THE DEVELOPMENT OF REGULATIONS FOR INSURANCE ACCOUNTING:

- I. **EARLY FORMS OF INSURANCE AND ACCOUNTING**--Italy developed a form of marine insurance and double entry bookkeeping in the 1300s.
England also developed early forms of insurance, including fire and marine insurance in the 1700s. The Industrial Revolution introduced England's large, manager-run businesses, which brought about more sophisticated accounting and auditing techniques.
The development of American insurance roughly paralleled that of English insurance. Incorporation in both countries often required businesses to prepare regular financial statements for their shareholders.
- II. **EARLY REGULATION**--In post-1792 America, states chartered their own insurers and set limits on insurer activities and investments.
Most states required regular financial statements and data filing.
In the 1820s, states began licensing insurers.
By 1853, all New York-incorporated insurers had to file a prescribed annual report.
Also in the 1850s, states began to examine their insurers.
In 1860, the New York State Insurance Department was created to regulate NY insurers, prescribe annual report format, and act as custodian to securities deposited by life insurers.
By 1870, many states had appointed state insurance regulators.
In 1905, New York formed the **Armstrong Committee**, which investigated the life insurance industry and discovered financial weaknesses among many insurers that resulted in more aggressive regulation of the insurance industry.
- III. **THE NAIC**--In 1871, to overcome regulatory diversity among individual states, NY's Superintendent of Insurance called the first annual meeting of insurance officials, known then as the **National Convention of Insurance Commissioners (NCIC)**, known, since 1936, as the **National Association of Insurance Commissioners (NAIC)**. **The NCIC and NAIC**
 - A. **created uniform statement blanks**--for asset, liability, expense, and rate filings.
The blanks were designed to emphasize (and they still emphasize) financial stability.
 1. **Assets**--In 1906, the NCIC recommended acceptable forms of investment for insurers.
In 1907, the NCIC established a **Committee on Valuation of Securities** to set uniform values for insurers' stocks and bonds.
 2. **Liabilities**--Liability insurers must maintain statutory minimum loss reserves.
 3. **Expenses and rates**--In 1911, New York required fire insurance ratemaking associations to file their rates and schedules. Other states followed.
In 1944, a US Supreme Court decision (**US vs. South-Eastern Underwriters Association aka The SEUA decision**) ruled that insurance *was* interstate commerce and *was* subject to Congressional regulation.
In 1945, Congress's **McCarran-Ferguson Act** delegated insurance regulation to the states.
In 1946, the NAIC's 'Commissioners All-Industry Bills' provided states with model rate regulatory laws for fire and casualty insurers.
The NAIC required every casualty insurer to file an annual **Casualty Experience Exhibit** with its state.
In the late 1940s, states began adopting legislation allowing multiple-line underwriting.

- B. **set uniform accounting rules**--In 1948, the NAIC's **Uniform Accounting Committee** adopted NY's uniform cost accounting standards and made them mandatory for all 1950 calendar year reporting. A revised Insurance Expense Exhibit was introduced in 1949 for all P-C insurers.
- C. **established a multiple-line blank**--In 1950, the NAIC adopted a **multiple-line blank** for fire and casualty insurers, which combined and condensed individual Annual Statement blanks into one blank. A new schedule divided expenses into claims, underwriting, and investment expenses and calculated the actual incurred total for each category. The Annual Statement blank's Schedule P has undergone many changes since 1950, expanding from seven to twenty-seven pages.

IV. CURRENT REGULATION--

- A. **State and NAIC regulation**--State laws limit the amount of insurance assets holding companies can divert from insurance use.
 - Fair Access to Insurance Requirements (FAIR) Plans** and other state-run insurance plans provide coverage for non-voluntary risks.
 - NAIC zone examinations** test insurers' financial conditions. Zone examinations and audits are governed by two publications (**Financial Condition Examiners Handbook** and **NAIC Model Market Conduct Examination Handbook**) and are performed by **The Society of Financial Examiners**.
 - Interaction between the NAIC and the **COIL (Conference of Insurance Legislators**--composed of state insurance legislators) has resulted in more uniform state insurance laws.
 - The Insurance Regulatory Information System (IRIS)** detects insurers in financial trouble.
 - The NAIC Financial Regulation Standards and Accreditation Program** certifies state insurance departments that meet NAIC Financial Regulation Standards.
 - The NAIC Solvency Agenda, adopted in 1990,**
 - 1. sets Financial Regulation Standards and risk-based capital requirements;
 - 2. recommends centralized financial statement analysis;
 - 3. seeks to expand the NAIC Education Program; *and*
 - 4. suggests ways to improve regulation of insurer investments, reinsurance evaluation, Annual Statement disclosure, financial examinations, solvency analysis, SAP, guarantee funds, and receivership functions.
 - The major outcomes of the Solvency Agenda include requirements that**
 - 1. insurer financial statement be audited annually by a CPA,
 - 2. actuarial opinions comment specifically on items that may materially affect reserves, *and*
 - 3. relate an insurer's required capital and surplus to the riskiness of its operations.
 - The Solvency Agenda has also prompted more effective insurer examinations.
 - Codification was developed** to provide a comprehensive guide to SAP *and* establish new SAP. Codification was initially adopted in 1998, to be effective in 2001, and is now part of the NAIC's manual, *Accounting Practices and Procedures*.
 - The forums for updating that manual include the NAIC's Statutory Accounting Principles Working Group (**SAPWG**) and the NAIC's Emerging Accounting Issues Working Group (**EAIWG**).
- B. **Federal regulation**--In the late 1960s, the federal government established reinsurance plans for fire, crime, and flood insurance and activated the Federal Insurance Administration.
 - The Occupational Safety and Health Act of 1970 (OSHA)** imposes employee safety and health inspection and reporting requirements.
 - The Resource Conservation and Recovery Act of 1976** regulates disposal of hazardous waste.
 - The superfund bill** provides for hazardous waste cleanup costs.
 - The Products Liability Risk Retention Act of 1981** permits risk retention groups under federal charter.
 - The Securities and Exchange Commission (SEC)** is concerned with asset valuation by publicly-held corporations. **Recent regulations include** the Federal Risk Retention Act, the Gramm-Leach-Bliley Act, *and* the Sarbanes-Oxley Act of 2002.

EO 2. **THE ROLES OF STATE GOVERNMENTS, THE NAIC, AND OTHER ENTITIES IN ESTABLISHING INSURANCE ACCOUNTING PRINCIPLES:**

1. **STATE GOVERNMENTS**--In 1948, the New York Department of Insurance developed the first insurance accounting principles in its Regulation 30.
2. **The NAIC**--The NAIC adopted New York's accounting principles and made them mandatory starting in 1950.
The NAIC published two accounting manuals: one for life and health insurers (1979) and one for property-casualty insurers (1980).
3. **Professional accounting associations--The American Institute of Certified Public Accountants (AICPA)** issued its audit guide for property and liability insurers in 1966. In 1982, its Financial Accounting Standards Board released **FASB Standard No. 60**, Accounting and Reporting by Insurance Enterprises, to guide insurers in completing their statements, starting in 1983.
4. **The insurance industry**--Our industry continues to expand its coverages and services, including more group coverages and **self-insurance**, in which the firm pays for its own losses and buys unbundled claims and safety services.
Periods of high interest rates have helped insurers generate profit despite poor loss and operating ratios and have encouraged innovative cash flow programs that required new collection recording methods.
Fluctuating interest rates have caused insurers to question using amortized bond valuations.
The reinsurance industry continues to expand. Rating bureaus now provide loss costs instead of rates.
New legislation has affected rating and cancellations.
Health care reform keeps the future of the health insurance industry unpredictable.

EO 3. **SOURCES OF STATUTORY ACCOUNTING PRINCIPLES (SAP):** SAP are derived from state insurance laws, regulations, and administrative rulings; the *Annual Statement Instructions: Property and Casualty*; the NAIC *Accounting Practices and Procedures Manual for Property/Casualty Insurance Companies*; the NAIC *Financial Condition Examiners Handbook*; the NAIC *Valuation of Securities* manual; NAIC meeting minutes; and accepted practices.
The NAIC's manual, *Accounting Practices and Procedures*, contains the NAIC's current **Statements of Statutory Accounting Principles (SSAPs)**, the primary accounting practices and procedures promulgated by the NAIC.

FUNDAMENTAL OBJECTIVES OF STATUTORY ACCOUNTING PRINCIPLES: SAP satisfy state insurance regulations by valuing assets conservatively to evaluate better the insurer's financial stability as an about-to-be liquidated concern.

EO 4. **CONTENT AND FILING REQUIREMENTS FOR THE ANNUAL STATEMENT:** **The Annual Statement** provides state insurance departments with information to regulate insurer solvency effectively and efficiently. The NAIC and its committees and task forces set the Annual Statement content, format, and filing requirements.

The Financial Condition Subcommittee reports to the NAIC Executive Committee.
Several standing task forces report to that Subcommittee.

The Blanks Task Force has primary responsibility for Statement content and format, supported by the Accounting Practices and Procedures Task Force.

The NAIC Annual Statement Instructions cross-reference sources among Statement exhibits and schedules for ease of cross-checking and give barcode instructions.

(Barcoding has the insurer print a bar code on its state forms to let state insurance departments check more easily that the insurer has filed its forms.)

Insurers should retain all Annual Statement worksheets for future examinations and audits.

1. **Title and jurat page**--shows the insurer's name; identification codes; statutory home office address; primary location of books and records; officers, directors, or trustees; contact person; and if the statement is an original or amended filing.
The **jurat** certifies the statement's accuracy and completeness and is signed by three responsible officers of the company.
2. **Financial statements and notes**--
 - a. **The Balance Sheet** states assets, liabilities, and owners' equities (policyholders surplus).
 - b. **The Statement of Income (aka Underwriting And Expense Exhibit)** reports net underwriting income gain or loss, investment income, other income, policyholder dividends, federal and foreign income taxes, and net income.
 - c. **The Statement of Cash Flow** reports **cash flow from operations** (underwriting, investment, and other income minus dividends and federal income taxes) separately from other cash flows.
 - d. **The Notes to the Financial Statements** disclose material information (accounting policies, basis for asset valuation) and additional details of Annual Statement summary information.
3. **Exhibits and schedules**--supply detailed information on assets, liabilities, income, and expenses.
 - a. **The Five-Year Historical Data Schedule** displays the five most recent years of key Annual Statement data.
 - b. **The Exhibit of Premiums and Losses** is different for each state but always reports business by line.
4. **General interrogatories**--ascertain compliance with laws and regulations, disclose additional information, and provide completion instructions for the Annual Statement.
5. **Statement of actuarial opinion**--gives an actuary's opinion of the loss and loss adjustment expense reserves.
The actuary must be
 - a. a member in good standing of the Casualty Actuarial Society,
 - b. a member in good standing of the American Academy of Actuaries and approved by its Casualty Property Council, *and/or*
 - c. a proven, competent actuary.
6. **Other schedules:**
 - a. **Schedule E** lists all deposits in excess of \$100,000 with banks, trust companies, S+L associations, and building and loan associations.
A special deposit schedule reports all deposits not held for the protection of all policyholders, itemized by jurisdiction.
 - b. **Schedule Y**--Information Concerning Activities of Insurer Members of a Holding Company Group lists and charts the interrelationships of all insurer affiliates.
7. **Annual Statement supplements:**
 - a. **The Insurance Expense Exhibit** is the primary regulatory report and the basis for NAIC profitability reports. It shows pre-tax statutory net income by line of business.
 - b. **The Stockholder Information Supplement** gives additional information on stock companies with 100 or more stockholders.
 - c. **Eighteen other reports:** Medical Malpractice Supplement, Financial Guarantee Insurance Exhibit, Accident and Health Policy Experience Exhibit, Credit Insurance Experience Exhibit, Medicare Supplement Insurance Expense Exhibit, Statement of Actuarial Opinion, Management's Discussion and Analysis, Long-Term Care Experience Reporting Form, Audited Financial Statements, SVO Compliance Certification, Trusteed Surplus Statement, Supplemental Compensation Exhibit, Risk-based Capital Reports, Combined Annual Statement, Stockholder Information Supplement, Premiums Attributed to Protected Cells Exhibit, Insurance Expense Exhibit, *and* Investment Risk Interrogatories.

EO 5. **ANNUAL STATEMENT USES:**

1. **NAIC Insurance Regulatory Information System (IRIS)**--identifies insurers facing impending financial trouble.
2. **Risk-based capital ratios**--use Annual Statement data to identify insurers needing regulatory scrutiny.
3. **Desk audits**--are performed within the insurance department.
Desk audits use Annual Statement data to
 - a. detect material errors *and*
 - b. analyze trends that might jeopardize solvency.
3. **Regulatory compliance**--Annual Statements must meet state regulations.
4. **NAIC profitability reports**--The Annual Statement and Insurance Expense Exhibit provide the data for NAIC profitability reports.
The NAIC profitability reports establish uniform standards for measuring insurer profitability and for comparing it with other insurers.
[Use the GAAP financial statements, especially the income statements, to compare insurers with non-insurers.]
The NAIC also publishes profitability reports by line of business, state, and industry aggregates. Insurers use profitability reports to evaluate their performances and to help establish premiums.
5. **Federal income taxes**--The Annual Statement's statutory accounting results help determine federal income tax liability.
The Annual Statement's "net income" and "taxable income" often differ due to
 - a. tax exempt interest income,
 - b. discounting of loss reserves,
 - c. unearned premiums, *and*
 - d. anticipated salvage and subrogation.
6. **Other uses**--Smaller insurers use the Annual Statement as an internal financial report and to compare their performances with other insurers.
Security analysts use Annual Statement data in their analyses.
Financial rating services use Annual Statement data to help compute ratings.
Many of the mentioned analyses use ratios, including the **combined (trade) ratio**, which combines the expense ratio and the loss ratio to indicate potential profitability.

EO 6. **THE NAIC SOLVENCY AGENDA** was covered in EO1., IV., A.

EO 7. **THE NAIC FINANCIAL REGULATION STANDARDS AND ACCREDITATION PROGRAM** was covered in EO1., IV., A.

*[Affiliated fire and casualty groups with more than one fire and casualty insurer use the **Combined Annual Statement**, which includes a title page; assets; liabilities, surplus and other funds; statement of income; cash flow; underwriting and investment exhibit, Parts 1 - 3; exhibits of net investment income, capital gains and losses, and insurance expenses; and Schedules D, F, H, P, T, and Z.]*

[Schedule Z is a three-part schedule that includes

1. companies included in the current year,
2. companies included in the current but **not** in the prior year, *and*
3. companies **not** included in the current but included in the prior year.]

[NAIC Quarterly Statements

1. are filed within 45 days after each calendar quarter and
2. use the same accounting and reporting principles as the Annual Statement.]

EO 8. **STATE REPORTING REQUIREMENTS IN ADDITION TO THE ANNUAL STATEMENT:**

1. **Filing requirements**--Every insurer must file its Annual Statement with the NAIC database and with all states, districts, and territories in which it is licensed.
Some states require additional documents.
States impose fines for late or incomplete filings.
2. **Mandatory CPA audits**--Every insurer must file an annual audit by an independent CPA as an Annual Statement supplement.
Some insurers qualify for consolidated audited statements.
Small insurers (less than \$1 million direct premiums written and fewer than 1,000 policyholders) are exempt from this CPA audit requirement.
The audit must be performed by a 'qualified' independent CPA, which means the CPA conforms to the standards of his profession and is in good standing with the American Institute of Certified Public Accountants (**AICPA**) and in all licensed states.
(Canadian and British CPAs must be chartered accountants.)
The annual audited financial report contains the
 - a. CPA's report,
 - b. balance sheet,
 - c. Statement of Operations,
 - d. Statement of Cash Flows,
 - e. Statement of Changes in Capital and Surplus, *and*
 - f. Notes to the Financial Statements.A CPA who finds an insurer to be in an adverse financial condition must report that finding to the insurer's board of directors or its audit committee in writing within five days.
A CPA who discovers deficiencies in an insurer's internal controls must report those deficiencies to the insurer, who then reports in writing to the domiciliary Commissioner.
3. **Financial condition examinations**--To remain accredited by a state, insurers need financial condition examinations every three to five years (as the state requires) or whenever the state insurance commissioner deems it necessary.
Some states separate the examination procedure into
 - a. a **financial condition examination** that focuses on financial and corporate matters *and*
 - b. a **market conduct examination** that focuses on sales and advertising practices, rating, and treatment of claimants and policyholders.The NAIC offers '**association examinations**' for insurers licensed in more than one NAIC zone or in more than three states in a single zone.
The state of domicile schedules companies for association examinations.
The lead state of a group of insurers (the state domiciling the parent company or largest subsidiary) schedules the entire group for examination.
Examination fees and travel expenses, which are paid by the insurers, vary from state to state.
4. **Statistical reports**--Insurers must file certain statistical premium and loss reports in their licensed jurisdictions.
Statistical filings are made through a statistical agency, which collects data from insurers, processes those data, and reports them to the appropriate state insurance departments for each insurer.